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Lending With Guaranties After *Deprizio* — Lenders, Guard Your Coffers; the Courts and Trustees are at the Gate

**INTRODUCTION**

As virtually every practitioner in the Bankruptcy and Banking areas should know, the Seventh Circuit Court of Appeals has added a troubling new wrinkle to the business of lending money, by its holding and opinion in *Levit v. Ingersoll Rand Financial Corp.* (In re V.N. Deprizio Construction Co.). For those who have not yet heard of or read the opinion, the central holding of the case is that where a lender extends a loan to a corporation and contemporaneously accepts the guarantee of an insider of the corporation to ensure repayment of the loan, and then accepts payments due under the loan within one year of the filing of bankruptcy by the corporation, the payments made to the lender are subject to recovery by the Trustee as avoidable preferences.

Since the *Deprizio* opinion was handed down, it has been the subject of much controversy and commentary. Additionally, two other circuits have now joined the Seventh Circuit in this matter, in each instance, soundly rejecting the "equity" and "two-transfer" approaches which had previously found support in a majority of

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1. 874 F2d 1186 (7th Cir 1989).
2. Id.
4. The Sixth and Tenth Circuits have done so in *Manufacturers Hanover Leasing v Lowrey (In re Robinson Bros. Drilling)*, 892 F2d 850 (10th Cir 1989) (per curiam), affg 97 Bankr 77 (W D Okla 1988) and *Ray v City Bank & Trust Co. (In re C-L Cartage Co.)*, 899 F2d 1490 (6th Cir 1990), reversing in part and affirming in part, 70 Bankr 928 (E D Tenn 1987).

As noted, the Tenth Circuit decision was rendered via a per curiam opinion. The Tenth Circuit simply affirmed the judgment of the district court and adopted its opinion. *Manufacturers Hanover*, 892 F2d 850. The district court's opinion was entered several months prior to the decision in *Deprizio* and therefore does not address that opinion.
the courts.\textsuperscript{5}

The purpose and scope of this comment will be to examine the history of avoidable preferences under the Code\textsuperscript{6} before Deprizio, scrutinize the opinion and rationale of Deprizio and its progeny, and finally explore the desirability and persuasive force of Deprizio’s rationale.

I. THE HISTORY OF AVOIDABLE PREFERENCES UNDER THE CODE BEFORE DEPRIZIO: JUDICIAL FICTION AND “EQUITY” REIGN SUPREME

When the bankruptcy laws were re-written in 1978,\textsuperscript{7} Congress substantially altered the law with regard to avoidable preferences, purportedly in order to bring such laws “into conformity with commercial practice and the Uniform Commercial Code.”\textsuperscript{8} The current Code section 547,\textsuperscript{9} which is the section governing preferences, is modeled after Section 60 of the Act with several significant changes.\textsuperscript{10} Under the Act, a trustee seeking to avoid a transfer as preferential had to prove both that the debtor was insolvent at the time of the transfer and that the preferred creditor had reason to

\begin{itemize}
  \item \textsuperscript{5} See notes 26-37 and the corresponding text.
  \item \textsuperscript{6} The Bankruptcy Code, 11 USC §§ 101 et seq (Colliers 1989).
  \item \textsuperscript{7} The former Bankruptcy Act of 1898, as amended by the Act of June 22, 1938, Pub L No 75-696, 52 Stat 840, was repealed in 1978 by Pub L No 95-598, § 401(a), 92 Stat 2549, 2682. For the sake of clarity and simplicity, the author will simply refer to the Bankruptcy Act of 1898 and its amendments as “the Act,” and will refer to the Bankruptcy Reform Act of 1978 and its amendments as “the Code.”
  \item \textsuperscript{8} H Rep No 95-595, 95th Cong, 1st Sess 372 (1977); S Rep No 95-989, 95th Cong, 2d Sess 87 (1978).
  \item \textsuperscript{9} 11 USC § 547, which provides in relevant part:
    \begin{enumerate}
      \item (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property -
        \begin{enumerate}
          \item (1) to or for the benefit of a creditor;
          \item (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
          \item (3) made while the debtor was insolvent;
          \item (4) made -
            \begin{enumerate}
              \item (A) on or within 90 days before the date of the filing of the petition; or
              \item (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
            \end{enumerate}
          \item (5) that enables such creditor to receive more than such creditor would receive if —
            \begin{enumerate}
              \item (A) the case were a case under chapter 7 of this title;
              \item (B) the transfer had not been made; and
              \item (C) such creditor received payment of such debt to the extent provided by the provisions of this title.
            \end{enumerate}
        \end{enumerate}
    \end{enumerate}
  \item \textsuperscript{10} The Bankruptcy Act of 1898, 30 Stat 544, as amended by the Act of June 22, 1938, Pub L No 75-696, § 60, 52 Stat 840, 870, repealed by the Bankruptcy Reform Act of 1978, (cited in note 7).
know of the debtor's insolvency. The Code has eliminated these requirements and has, in fact, created a statutory presumption that the debtor was insolvent during the entire 90-day period prior to the filing of the petition.

Thus, under the Code, in order for a trustee to avoid any transfer, he or she must simply establish the existence of the following criteria: 1) that a transfer was made to, or for the benefit of, a creditor, 2) for or on account of an antecedent debt owed by the debtor, 3) which was made while the debtor was insolvent, 4) and was made either on or within 90 days of the filing of bankruptcy, or, if the creditor is an insider of the debtor, between 90 days and one year before the filing, and 5) which transfer permits the creditor to receive more than it would have received had the transfer not been made or, which permits the creditor to receive more that it would have received in a Chapter 7 liquidation. Under a typical scenario, recovery by the trustee of preferential payments works to the benefit of all of the creditors. Rather than permit one creditor to be benefitted or "preferred," to the detriment of all other creditors, the Code has provided the mechanism for the recovery of these preferential transfers of assets so that such assets are available for distribution via a pre-determined formula for such

11. Id.

12. 11 USC § 547(f) provides in its entirety: "For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."

The requirement that the trustee establish knowledge by the insider of the debtor's insolvency was removed in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub L No 98-353, 98 Stat 333 (1984). Subsection (b)(4)(B) of Pub L No 98-353, § 462(b)(2), (codified at 11 USC 547(b)(4)(B), substituted "between ninety days and one year before the date of filing of the petition, if such creditor at the time of such transfer was an insider . . ." for "between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer - (i) was an insider; and (ii) had reasonable cause to believe that the debtor was insolvent at the time of such transfer; . . ." 11 USC § 547 (Cum Supp 1990 p 60, under the heading "Historical and Statutory Notes").

13. 11 USC § 547(b) (cited in note 9).

14. As one commentator has explained,

The vulnerability of eve-of-bankruptcy collections is nothing new. When an insolvent debtor chooses (or is forced) to pay one of its general unsecured obligations, the recipient creditor is preferred—that is, the creditor gets more than it would through the system of priorities and pro rata participation that governs distribution in liquidation under chapter 7 of the Bankruptcy Code. To foster Congress’ prescribed treatment for all creditors and to discourage a destructive race for assets, sections 547 and 550 of the Bankruptcy Code allow a trustee first to avoid certain preferential transfers and then to recover their value for redistribution through the bankruptcy estate. Katzen, Deprizio, 45 Bus Law 511, 512 (cited in note 3).
The problem which arose in *Deprizio* was created largely by the literal and relatively straightforward language of Section 547, when read in combination with Section 550 and the definitional sections. Under the definitional sections, "creditor" is any entity with a claim against the debtor. "Claim," on the other hand, is so expansively defined as to include every right to payment, whether "fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." When one examines the first criterion for avoidance under section 547 in light of these definitions, the potential exposure of the outside creditor who accepts an insider guaranty comes more clearly into focus. An insider of a corporation who gives his or her guaranty on a debt owed by the corporation clearly becomes, upon granting such guaranty, an entity with a right of payment, albeit contingent and unmatured, from the corporation. Thus, assuming *arguendo* that the other factors necessary to establish a preference exist, any payments made by the debtor in satisfaction of the debt guaranteed by the insider are, by the express and literal language of the statute, transfers "for the benefit of a creditor" and would

15. Id.
16. 11 USC § 550 is the Code section which permits a trustee to recover the assets which were transferred to the extent to which those transfers can be avoided under, *inter alia*, section 547. The full text of the relevant part of section 550 provides:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from -

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

The definitional sections are found at 11 USC § 101, and provide in relevant part as follows:

(9) "creditor" means -

(A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;

(4) "claim" means -

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . .

17. 11 USC §101(9)(A).
18. 11 USC § 101(4)(A).
19. When read together, the definitional sections and section 547 simply require the trustee to show that a transfer was made to, or for the benefit of, an entity which holds a right to payment against the debtor, no matter how contingent, disputed or unmatured that right to payment might be. 11 USC §§ 547(b)(1) and 101(4)(A).
be preferential, and thus avoidable, by a trustee. Because section 547(b)(4)(B) extends the preferential period from 90 days to one year in cases where the "creditor" is an insider of the debtor, this extended reachback period could be applied to the outside creditor in the above scenario. This is so because each payment to the outside creditor is a payment "for the benefit of" the insider guarantor, as it reduces the guarantor's contingent liability on the debt.

Add to this analysis the language of section 550, permitting the trustee to recover any such preferential transfers from either the initial transferee (for example, the outside creditor/lender in the above scenario) or the entity for whose benefit the transfer was made (for example, the insider guarantor), and you have the recipe for Deprizio.

So why the shock when the Seventh Circuit adopted the brave stance that sections 547 and 550 mean exactly what they say? In fact, given the literal language of these sections of the Code, how can it reasonably be argued that the result reached in Deprizio was somehow unforeseen? As far back as 1981, at least one commentator was predicting the result in Deprizio based purely on a literal reading of the Code.

20. 11 USC §§ 101(4)(A), 101(9)(A), 547(b) and 550(a).
21. 11 USC §§ 547(b)(4)(B).
22. 11 USC § 550(a)(1).
23. Thomas E. Pitts, Jr., in his article entitled Insider Guaranties and The Law of Preferences, examined the literal language and potential impact of Code sections 547 and 550 in light of a hypothetical set of facts which are remarkably similar to the facts in Deprizio. Mr. Pitts' hypothetical was as follows:

The following unexceptional set of facts will form the basis for our analysis. Two years prior to the filing of the petition, Bank made an unsecured term loan to Debtor requiring monthly payments, all of which are paid on time up to the date that Debtor files a petition under the Code. Guarantor is the principal stockholder and president of Debtor and has guaranteed its indebtedness to Bank. The evidence is clear that (1) Debtor was insolvent during the entire year preceding the filing of the petition, (2) Guarantor had reasonable cause to believe that such was the case, and (3) each payment during that year enabled Bank to receive more than it would have received under chapter 7 of the Code absent that payment. The evidence is equally clear, however, that Bank was not an insider at any time during that year and never had reasonable cause to believe Debtor was insolvent.


This "unexceptional set of facts" lead Mr. Pitts to the unexceptional conclusion that "each payment 'to' Bank was also 'for the benefit of' Guarantor because it reduced his contingent liability to Bank under the guaranty.... Consequently, these last three payments to Bank were voidable preferences for the additional reason that they were made 'for the benefit of a creditor' who thereby received a benefit equally as disproportionate as the benefit received by Bank." Id at 345.

It should be noted that Mr. Pitts' work was written and published before the 1984 amend-
The shock at the Seventh Circuit’s result most likely stems from the prior judicial treatment of the issue. While no circuit court had ever ruled on the issue, several lower courts had reached the same result as the Seventh Circuit.\(^2\) This approach, however, was still in the minority.\(^2\) Prior to this, most courts which had considered the issue had held that the outside creditor could not be held liable in such circumstances. These courts had primarily adopted one of two approaches in order to avoid imposing liability on such a creditor. As will be demonstrated below, most courts purported to give effect to the actual language of the Code, all the while, protecting the outside creditor. Only the courts employing the “equitable considerations” approach explicitly acknowledged that such a reading was inconsistent with a literal interpretation of the language of the statute.\(^2\)

An evaluation of these differing judicial approaches is warranted in order to understand the confusion and controversy created by the Seventh Circuit.

Beginning in approximately 1984, a dichotomy of approaches began to develop with regard to the liability of outside creditors for transfers made during the extended preference period.\(^2\)

\(^2\) Ments to the Code, which among other things, eliminated the requirement that the Trustee establish that the insider guarantor had reason to believe that the debtor was insolvent during the entire year preceding the filing of the petition. See note 11. This fact is clearly indicated by the slight difference in his hypothetical, but does not affect our analysis here, nor does it alter his prophetic analysis in 1981.


26. The “equity,” or “equitable considerations” approach as it has become known, calls upon a court to invoke its equitable powers under 11 USC § 105(a) and 28 USC § 1481 in order to avoid the inequitable result of holding an outside creditor liable for payments made during the extended preference period applicable to insiders. See notes 33-37 and the corresponding text.

27. Prior to the decision in *In re Mercon Industries,* (cited in note 28), only a handful of cases had been decided on the issue of outside creditor liability for transfers made between 90 days and one year before the filing of the petition. See notes 25 and 34, and the cases cited therein. It was the decision in *In re Mercon Industries* which created the dichotomy of “majority” approaches, that is, the dichotomy between the majority of the courts (these are hereinafter referred to as the “equitable approach” and the “two-transfer theory”). The cases cited in note 25, which predate both *Mercon* and *Deprizio* but which follow
year, the United States Bankruptcy Court for the Eastern District of Pennsylvania handed down its decision in *In re Mercon Industries*.\(^{28}\)

The case presented for consideration in *In re Mercon Industries* involved a familiar set of facts; the trustee had filed a complaint against an outside creditor of the debtor in order to recover payments made on the debt within one year of the filing of the petition. These debts were guaranteed by two insiders of the debtor corporation. On the defendant’s Motion to Dismiss the Complaint for failure to state a cause of action, the court, speaking through Judge Goldhaber, ruled that the outside creditor could not be held liable for such payments under sections 547(b) and 550. In so ruling, the court held that “the single transfer of funds to Goldman effected two transfers under the Code, due to the secondary liability of the guarantors. One transfer was from the debtor to Goldman in satisfaction of the primary indebtedness. The other was the transfer to the guarantors in satisfaction of their contingent liability.”\(^9\) The court noted that section 547 only permits avoidance of transfers to outside creditors within a limited 90-day window, the longer one-year period being reserved exclusively for transfers to insiders.\(^{30}\) Therefore, only the transfer to the guarantors could be avoided.

Enunciating what has become known as the two-transfer theory, the court stated that its position was supported by the language of sections 547 and 550, as well as “a noted commentary on the Code,” namely, Collier.\(^{31}\) Section 550 supports the result, reasoned

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the *Deprizio* result, constitute a third approach. This third approach, following *Deprizio*, has emerged as a separate majority (hereinafter and heretofore referred to as the “*Deprizio* approach”), thereby creating a triad of judicial approaches to the problem.

Purely for purposes of classifying the approaches into categories, those cases which were decided prior to the 1984 Amendments to the Code were enacted, see note 12, have been ignored. Granted, those cases could easily be categorized into a fourth category, known as the “combination equitable/literal interpretation approach.” See for example, *Sheeley v Church Buildings and Interiors, Inc. (In re Church Buildings and Interiors, Inc.),* 14 Bankr 128 (W D Okla 1981); *Bakst v Schilling (In re Cove Patio Corp.),* 19 Bankr 843 (S D Fla 1982) and *Backhus v Central Trust Company (In re Duccilli Formal Wear, Inc.),* 8 BCD 1180 (Bankr S D Ohio 1982).


29. *Goldberger,* 37 Bankr at 552.

30. Id.

31. Id at 551 (citing 4 *Collier on Bankruptcy* ¶ 550.02, at 550-7 (15th ed 1983)). The passage quoted from Collier states in full:

(I)f a transfer is made to a creditor who is not an insider more than 90 days but within one year before bankruptcy and the effect is to preferentially benefit an in-
the Court, that "the mediate transfer to the insiders may be an actionable preference under Section 547(b) although the immediate transfer to Goldman is not."32

Thus, while purporting to give effect to the literal language of the statute, the two-transfer approach causes one to engage in some significant mental gymnastics. Some courts have referred to this approach as a fiction,33 while at least one commentator has noted that it requires a tortured construction of the statute.34

The second judicial approach to the problem has been based on "equitable considerations," thereby forcing a bankruptcy court to call upon its equitable powers.35 The courts adopting this approach have typically acknowledged that a literal reading of sections 547(b) and 550 support an action for recovery against the outside creditor, but invoke their equitable powers, and generally Collier as well, to avoid that result.36

sider-quarantor, recovery should be restricted to the guarantor and the creditor should be protected. Otherwise a creditor who does not demand a guarantor can be better off than one who does.

Id.

32. Goldberger, 37 Bankr at 552 (footnotes omitted).


34. See Note, The Interplay Between Sections 547(b) and 550 of the Bankruptcy Code, 89 Colum L Rev 530, 534 (1989).

35. The equitable powers which are conferred upon the courts, pursuant to 11 USC section 105(a), include "issu[ing] any order, process, or judgment that is necessary or appropriate to carry out the provisions ..." of the Code.

The portion of Collier's treatise on bankruptcy, cited in note 33, also cites the equitable powers of a bankruptcy court, which are conferred in 28 USC section 1481. As one commentator has noted, quite accurately,

Section 1481 reads in relevant part: 'A bankruptcy court shall have the powers of a court of equity ...' [28 USC § 1481.] Although this section was to become effective April 1, 1984, Bankruptcy Reform Act of 1978, Pub L No 95-598, § 402(b), 92 Stat 2549, 2682, it was repealed before it took effect by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub L No 98-353, § 113, 98 Stat 333, 343.

See Note, 89 Colum L Rev 530, 536, n.32 (cited in note 34).


The passage from Collier which is most frequently invoked in the cases which apply equitable considerations provides as follows: "In some circumstances, a literal application of section 550(a) would permit the trustee to recover from a party who is innocent of wrongdoing and deserves protection." 4 Collier § 550.02, at 550-58 (cited in note 3). In such circumstances the bankruptcy court should exercise its discretion to use its equitable powers under section 105(a) and 28 USC Section 1481 to prevent an inequitable result. Id.
In *Ray v City Bank & Trust Co. (In re C-L Cartage Co., Inc.)*, the United States Bankruptcy Court for the Eastern District of Tennessee applied this equitable approach to deny recovery by the trustee, of monies paid by the debtor to an outsider bank, outside the 90 day preference period but within the one-year period, even though the monies paid were in satisfaction of a debt of an insider of the debtor and the payments were made by the debtor. The court there stated, in relevant part:

The trustee generally can recover preferential payments only if they were made within the 90 days before the date on which the bankruptcy petition was filed. However, preferential transfers to an insider . . . can be recovered if they were made within a year before bankruptcy. A literal reading of Sections 547(b)(1) and 550(a)(1) would allow the trustee to recover preferential payments to a non-insider creditor made more than 90 days but within a year before the bankruptcy if the payments also preferred an insider. Most courts, however, have rejected this interpretation of the statutes. They have held that insider preferences outside the 90 days can be recovered only from the insider. The court agrees with the majority . . .

Thus, the court rejects a literal reading of Section 550(a)(1) on this point.

Thus, while admitting that the Code provides for such a result, numerous courts have refused to apply the Code as written, and have simply focused on reaching an "equitable" result.

**II. Deprizio: strict construction and the Seventh Circuit**

The opinion and rationale of the unanimous panel of the Seventh Circuit in *Deprizio* has been examined so thoroughly and exhaustively that lengthy analysis here would not be fruitful or even helpful. The essential elements of the court's opinion can be

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37. 70 Bankr 928 (E D Tenn 1987). Note that the bankruptcy court's decision in this case was affirmed by the district court but reversed by the Sixth Circuit. See notes 4 and 52-60 and the accompanying text. Nonetheless, the bankruptcy court's opinion still represents an accurate depiction of the approach taken by the majority of lower courts that have considered the issue before *Deprizio*.


39. See for example, *In re Midwestern Companies* and the following language used by the Bankruptcy Court therein:

[I]t has long been recognized that a preference action is a creature of equity and that the bankruptcy courts, in employing the doctrine, are to apply equitable principles. The case decisions which have held that recovery cannot be had against a bank in circumstances such as those at bar have simply seized upon the obvious unfairness and inequity of permitting the trustee to recover under such circumstances.


40. See for example, *Katzen, Deprizio*, 45 Bus Law 511 (cited in note 13); and
highlighted in relatively short order.

According to the Seventh Circuit, the text of the bankruptcy statute mandates that if the transfer is avoidable under section 547(b), the court must permit the trustee to exercise his or her option under section 550(a), to recover from either the initial transferee or the entity for whose benefit the transfer was made. This textual argument is controlling for the court; no other theory of construction is persuasive when faced with the clear language of a statute such as here.

The two-transfer theory was unavailing. Such an approach, according to the court, requires that one view transfer from the recipients' perspective while the Code "consistently defines it from the debtor's. A single payment therefore is one 'transfer', no matter how many persons gain thereby."

The "equitable considerations" argument was not even raised by the creditors. Nonetheless, the court examined the "equity arguments (which) have captivated a majority of the bankruptcy judges and several of the commentators who have spoken on this subject," concluding the analysis with this query:

At all events, in what sense is it 'inequitable' to recapture payments to creditors that may have been favored only because payment reduced insiders' exposure (recall that the insiders select which debts to pay first), then distribute these monies according to statutory priorities and contractual entitlements? In what sense is it 'inequitable' to require the outside lenders to pursue the inside guarantors for any shortfall, when they bargained for exactly that recourse?"

The "cousin to 'equity' arguments," or policy arguments, were

Borowitz, Waiving Subrogation Rights and Conjuring Up Demons in Response to Deprizio, 45 Bus Law 2151 (August 1990) and the materials cited therein at n.2. See also, the materials cited in note 3.

41. Deprizio, 874 F2d at 1195-96.
42. The court noted in this regard, "Perhaps our rebuff to 'equity' arguments in other bankruptcy cases is responsible." Deprizio, 874 F2d at 1197 (citations omitted).
43. Id at 1198.
44. Id at 1198. In examining the equity argument, the court noted: Rules of law affecting parties to voluntary arrangements do not operate 'inequitably' in the business world—at least not once the rule is understood. Prices adjust. If the extended preference period facilitates the operation of bankruptcy as a collective debt-adjustment process, then credit will become available on slightly better terms. If a longer period has the opposite effect, creditors will charge slightly higher rates of interest and monitor debtors more closely. In either case creditors will receive the competitive rate of return in financial markets—the same risk adjusted rate they would have received with a 90-day preference-recovery period.

Id.

45. Id.
similarly unpersuasive for the court. The creditors argued that the extended preference-period liability for outside creditors would cause the lenders to "precipitate bankruptcy filings at the slightest sign of trouble in order to prevent erosion of their positions." One result of such a situation, argued the creditors, is that workouts will occur less frequently and formal bankruptcies will become the norm. This is because workouts frequently involve guaranties, and the extended preference period, in instances where there is an insider guaranty, will discourage workouts.

Again, the court was unpersuaded by these arguments, noting that "unless there is a 'preference,' there is nothing for the trustee to avoid." The panel then proceeded to analyze all of the available exclusions contained in section 547(c) stating, "[i]t is enough to observe that Section 547(b)(5) and (c), . . . exclude from recovery the bulk of ordinary commercial payments." Ultimately, the court concluded that:

In light of these exclusions, there is no reason to use ambulatory arguments of 'equity' or 'policy' to defeat the Trustee's claims in this case. Congress has considered and addressed specifically the situations that most concern lenders. If these exclusions and exemptions are not 'enough,' creditors should complain to Congress.

With these words and many others, the Seventh Circuit opened the gates to the coffers of lenders, thereby sending the financial community into a state of extreme unease and uncertainty.

III. ENTER, THE OTHER CIRCUITS

Had Deprizio been the only case which held that an outside creditor could be made to disgorge all payments made by a debtor during the entire year preceding bankruptcy, simply because the lender had required an inside guarantor, it would have been reason enough for concern by lenders. But, since the Seventh Circuit's opinion, two other circuits have also so held, and an appeal to the Eighth Circuit was settled before any opinion was rendered. It
seems clear that the issue will not die with the Seventh Circuit’s opinion but will continue until there is 1) a split in the circuits sufficient to prompt the Supreme Court to grant certiorari,52 2) a consensus among the circuits, adopting or rejecting the rationale of Deprizio, or 3) Congressional action which alters the current state of the law. With this in mind, turning to an analysis of the other circuits’ opinions in order to examine what is happening at least on that front will be helpful.

In the Sixth Circuit,53 the president of the debtor corporation took out personal loans in order to finance the business operations of the debtor corporation.54 These loans were cosigned by the president’s mother and secured by certificates of deposit.55 Within the year preceding the filing of the petition by the debtor corporation, numerous payments were made by the corporation in reduction of the personal debt of its president. Most of these payments were made directly to the bank by the corporation, while several were made payable to the cosignor and were then endorsed over to the bank.56 Thereafter, the trustee brought an action against the bank seeking to recover these payments, alleging that such payments constituted preferential transfers.

The Sixth Circuit, like the Seventh Circuit, adopted a literal-reading approach in order to hold that the funds paid to the outside creditor, during the extended preference period, could be recovered by the trustee.57 In the course of so holding, the Sixth

52. US S Ct Rule 10(1)(a). This rule provides that where there is disagreement between the Circuits on the same matter, such is of the character of reasons which the Supreme Court will consider in determining whether to grant certiorari.
54. The court explained the facts on this issue as follows: In March 1983, Carlos Foster, president of C-L Cartage Company (“Cartage”), the debtor, approached City Bank and Trust Company (“the bank”) for financing. The bank refused to lend money to the company but agreed to make a personal loan to Carlos of $30,000, on the condition that his mother . . . cosign the note and secure it with certificates of deposit. . . . Carlos transferred the funds to Cartage to finance its business operation. No promissory notes were signed or delivered by Cartage to the Fosters.
55. Id at 1491.
56. Id. See note 54.
57. Id at 1494-95. The court stated in relevant part:
A literal reading of section 550(a)(1), together with sections 547(b)(1) and (b)(4)(B), permits recovery from an outsider transferee for transfers made during the extended
Circuit also rejected outright the equity arguments, stating "(b)ankruptcy courts . . . cannot use equitable principles to disregar[d] unambiguous statutory language."58

A different, but related, issue in the C-L Cartage case may prove to be even more troubling to lenders. That issue regards the bank's argument that because its loans to the insiders were fully secured, the trustee could not establish the existence of the fifth element required for a preference.59 The court agreed that "[p]ayments to a creditor who is fully secured are not preferential since the creditor would receive payment up to the full value of his collateral in a Chapter 7 liquidation."60 The Sixth Circuit, however, held that it was the loans to the company from the insider (which were unsecured), not the loans from the bank to the insider, which permitted the "creditor" (the insider) to receive more than he would have received in a Chapter 7 liquidation.61 This aspect of the Sixth Circuit's opinion will be the subject of additional commentary in the next section of this work, which section touches on some alternatives to Deprizio-type lending.

The Tenth Circuit simply issued a per curiam opinion affirming the district court's opinion.62 Therefore, one must return to the underlying appeal in order to consider any relevant analysis in that circuit.

At issue before the district court was the trustee's appeal from the bankruptcy court's order granting summary judgment.64 A brief excerpt from the bankruptcy court's order granting summary judgment provides sufficient factual exposition and insight into the case to permit meaningful analysis. The bankruptcy court's order provided, in relevant part:

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58. Id.
59. Id. at 1493. That requirement is found in 11 USC § 547(b)(5) and dictates that the transfer must enable the creditor to receive more than it would have in a Chapter 7 liquidation.
60. Ray, 899 F2d at 1493.
61. Id.
62. See notes 4 and 50.
64. In re Robinson, 97 Bankr at 97.
The Trustee, under these circumstances, cannot utilize 11 U.S.C. Section 550(a) to recover payments received by defendants who hold guarantees of J.D. Hodges, an insider of debtor, outside of the 90 day period and within one year of the filing of bankruptcy. Furthermore, the [Bankruptcy] Court finds that a reading of 11 U.S.C. Section 550(a) does not indicate that Congress explicitly intended to circumvent 11 U.S.C. Section 547 by permitting recovery for transfers outside of the 90 day period and within one year from non-insider creditors. Based upon the ambiguities in 11 U.S.C. Section 550, the [Bankruptcy] Court must consider the equities involved. A review of the equitable considerations and long settled credit practices involving guarantees, mitigates against permitting recovery from the non-insider creditors. 68

In reversing the bankruptcy court’s order, the district court noted the differing schools of thought, 67 acknowledging that the majority of lower courts considering the issue have employed either the “two-transfer” theory, or the “equitable power” of the bankruptcy court, to deny recovery by the trustee. 68 The district court then fully explored the majority approaches and the minority approach of strict statutory construction, ultimately siding with the latter. 69

Thus, of the two circuits which have now decided the same issue presented to the Seventh Circuit in Deprizio, both have decided the issue based entirely on a literal reading of the statutory language. Additionally, all three circuit courts having decided the issue to this date have soundly rejected what had heretofore been the two majority approaches.

IV. THE IMMUTABLE LOGIC OF STRICT CONSTRUCTION

There is a certain irresistible logic to the circuits’ strict construction approach. By its plain language, the statute indicates which transfers are to be treated as preferential. 70 Further, the statute indicates the options for recovery which are available to the trustee, should the transfers be deemed preferential. 71 Why then, when faced with such unambiguous statutory language, should the courts feel constrained to engage in “equities analysis” or adopt

67. Id at 79-81.
68. The court stated in this regard:
The majority view among lower courts who have decided the issue is supported by either the ‘two-transfer’ theory . . . or by relying on the equitable powers of the bankruptcy court under 11 U.S.C. Section 105 to prevent injustice, or both. In re Robinson, 97 Bankr at 81 (footnote omitted).
69. Id at 82-83.
70. 11 USC § 547(b).
71. 11 USC § 550.
fictional transfers in order to avoid the result which the statute clearly dictates?

The courts and the commentators are in agreement that there is no helpful legislative history to guide or temper the reading of the statute in any manner.\textsuperscript{72} Some advocates, however, have argued that this lack of legislative history indicates that Congress meant to "preserve the practice, under the Bankruptcy Act of 1898, of recovering payments only from those to whom the transfer represented a preference . . . on the theory that if Congress made a change as momentous as this, surely someone would have said so."\textsuperscript{73} This argument, however, ignores the fact that someone did say so: Congress did, when the lengthy process of re-writing the bankruptcy laws resulted in the enactment of a Code which contained sections 547 and 550 in their present form.\textsuperscript{74} After a lengthy and scholarly analysis of the above argument, the Seventh Circuit summarily put the argument to rest with the following, well-considered epitath: "[s]ilence in the legislative history therefore does not require or authorize a court to depart from the text and structure of the Code."\textsuperscript{75}

\textsuperscript{72} See for example, 
\textit{Levit v Ingersoll Rand Financial Corp. (In re V.N. Deprizio Construction Co.)} 874 F2d 1186, 1196 (7th Cir 1989).

\textsuperscript{73} Id (citations omitted).

\textsuperscript{74} When this "lack of legislative history argument" was raised before the Seventh Circuit, the court responded as follows:

Yet 'it is not the law that a statute can have no effects which are not explicitly mentioned in its legislative history'. . . When Congress makes wholesale changes in the text and structure of the law, it is fatuous to pretend that a silent legislative history means that existing practices should continue unchanged. The 1978 Code separates the identification of avoidable transfers (§547) from the identification of those who must pay (§550), a structural change with no antecedents in the 1898 Act. It also creates for the first time the principle that transfers may be recoverable from either transferee or beneficiary - something introduced to § 550(a)(1) in the Conference Committee, too late for comment in the usual committee reports. Changes of this character show that the pre-1978 practice is not a useful guide to interpreting the relation between §§ 547 and 550.

\textit{Deprizio}, 874 F2d at 1196-97 (footnotes and citations omitted).

\textsuperscript{75} Id at 1197 (citations omitted). This comment does not entirely ignore the thought-provoking question of "how we read the Bankruptcy Code." See for example, Mark D. Yochum, \textit{How We Read the Bankruptcy Code}, 23 Juris 4 (Summer 1990) (citing \textit{Midlantic National Bank v New Jersey Department of Environmental Protection}, 474 US 494 (1986), \textit{Kelly v Robinson}, 479 US 36 (1986), and \textit{In re Ron Pair}, 109 US 1026 (1989)). This line of cases, however, seem only to confuse the issue. The \textit{Midlantic} decision seems to indicate that specific congressional intent is required in addition to specific code language, in order to alter the law in a specific instance. Justice Powell, writing for the majority, suggested the above conclusion in the following passage:

The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific.
Numerous other commentators have argued against a strict application of the actual statutory provisions, arguing that to apply the statute as written would work great inequities and permit numerous unintended evils. It may well be true that certain results under the preference sections of the Code were not literally intended by the drafters. Still, does this justify ignoring the literal language in pursuance of the desired result in each instance? To permit the courts to decide the desired result on a case-by-case basis and then to interpret the statute accordingly would be to throw out the baby with the bath water. There already exists a clear, concise statute which indicates what is to be done, given the existence of certain factors. If the results that are reached by a literal application of that statute are not desireable, then perhaps additional legislation is required. But the legislation which is indicated in such an instance is congressional, not judicial. Besides, as the Seventh Circuit has indicated, the vast majority of commercial payments will still be insulated under the defenses contained in Section 547(c).

Midlantic, 474 US at 501.

The decision in Kelly v Robinson, seems to be in agreement with the method of statutory construction espoused in Midlantic. At the other end of the spectrum, however, is In re Ron Pair, in which the majority permitted traditional bankruptcy doctrine to be altered significantly by simple resort to a plain reading of the Code.

Thus, the author concludes that the cases cited do not provide consistent input on the question of "How we read the Bankruptcy Code."

76. See for example, Katzen, Deprizio (cited in note 3): 4 Collier, § 550.02 at 550-57 (cited in note 3).

77. As the court indicated, "[i]t is enough to observe the § 547(b)(5) and (c) . . . exclude from recovery the bulk of ordinary commercial payments. Deprizio, 874 F2d at 1196-97. 11 USC section 547(c) provides in full:

The trustee may not avoid under this section a transfer-

1. to the extent that such transfer was-
   (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
   (B) in fact a substantially contemporaneous exchange;

2. to the extend that such transfer was-
   (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
   (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
   (C) made according to ordinary business terms;

3. that creates a security interest in property acquired by the debtor-
   (A) to the extend such security interest secures new value [in the nature of a purchase-money security interest] . . .

4. to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor-
   (A) not secured by an otherwise unavoidable security interest; and
While it may initially appear that the literal application of the preference sections may be inequitable in certain situations, most notably the *Deprizio*-type situation, the persuasive logic behind applying a statute as written far outweighs any perceived inequities. Adherence to a strict and predictable course of treatment in a given situation is virtually as important in statutory construction as is reading the words of the statute for what they say; not what one wants them to say. In fact, the argument could be made that only when the “rules” keep changing is the application of this portion of the Bankruptcy Code, as written, somehow inequitable. Once again, the Seventh Circuit’s eloquent analysis of the problem bears repeating:

Rules of law affecting parties to voluntary arrangements do not operate ‘iniquitably’ in the business world - at least not once the rule is understood. Prices adjust. If the extended preference period facilitates the operation of bankruptcy as a collective debt-adjustment process, then credit will become available on slightly better terms. If a longer period has the opposite effect, creditors will charge slightly higher rates of interest and monitor debtors more closely. In either case creditors will receive the competitive rate of return in financial markets - the same risk-adjusted rate they would have received with a 90-day preference-recovery period. A rule may injure debtors and creditors by foreclosing efficient business arrangements and increasing the rate of interest low-risk borrowers must pay, but inefficiency is not inequity.78

In the *Deprizio*-type situation itself, aren’t there really options other than engaging in fiction-writing or “equity” analysis? For example, when the trustee files suit against the outside creditor (the lender), seeking to recover the payments made which were in reduction of the contingent liability of the insider creditor (the guarantor), why not simply allow the outside creditor to join the guarantor in the recovery action. In such a scenario, all of the parties to the arrangement are before the court at one time. The court can

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;
(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction . . . . to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on [one of three defined dates] . . .
(6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title; or
(7) [aggregate transfers of less than $600 for an individual debtor].
78. *Deprizio*, 874 F2d at 1198 (citations omitted).
then act in a fashion which is both consistent with the statute and which prevents duplicative and circuitous litigation.

Some will undoubtedly argue that the guarantor is likely insolvent as well. This argument would seem to ignore both the purpose of requiring an insider guarantor, and the diligence required of a lender who accepts such a guarantee. There are, arguably, but two purposes to be served by an insider guarantee, one of which is legitimate and the other, judicially and statutorily abhorred. The legitimate purpose of such a guarantee is that in the event of default on the part of the principal obligor, the guarantor will "stand" for the debt and be obligated as well as able to make payment. To achieve both obligation and ability requires lender diligence. The other, or illegitimate purpose, arises when the lender accepts the guarantee of an insider whom the lender knows cannot possibly satisfy the obligation if called upon to do so. In such a circumstance, the only ascertainable purpose for the guarantee is to assure that the guaranteed obligation will be satisfied or, reduced first, in the event of financial difficulty on the part of the principal obligor (of which the guarantor is an insider), in the preference over the other creditors. Such is the action which sections 547 and 550 were designed to prevent.

In addition, there exist preventive measures which lenders can adopt in order to prevent the harm of which all seem concerned. The first such remedy is really more common sense than advice, but it bears consideration. Hereinafter, lenders must carefully review the necessity of demanding a guarantee from an insider, given the holding of Deprizio. If some other form of security will achieve the same result, absent the trustee's recovery, then a lender should strongly consider opting for the alternative security. Along the same lines, lenders should consider collateralizing their interest with goods or equipment of the debtor corporation and/or requiring a purchase money security interest in the goods or equipment, as the circumstances dictate.

While the current state of the law on avoidable preferences offers lenders more grief than guidance, all is not lost to the lender who is willing to consider alternative security measures. In so doing, cautious and sophisticated lenders can probably avoid the Deprizio trap.

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